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TESTIMONY OF CHRISTINE A. BRUENN

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And
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Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Regarding H.R. 2179

The Securities Fraud Deterrence and Investor Restitution Act of 2003

June 5, 2003

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee,

I'm Christine Bruenn, Maine's Securities Administrator and President of the North American Securities Administrators Association, Inc. (NASAA).[1] I commend you for holding this hearing, and thank you for the opportunity to appear before your Committee to present the states' views on H.R. 2179, The Securities Fraud Deterrence and Investor Restitution Act of 2003.

Overview

First, let me give you a brief overview of state securities regulation, which actually predates the creation of the SEC and the NASD by almost two decades. The securities administrators in your states are responsible for the licensing of firms and investment professionals, the registration of some securities offerings, branch office sales practice audits, investor education and, most importantly, the enforcement of state securities laws. Some of my colleagues are appointed by their Governors or Secretaries of State, others are career state government employees. Notably, only five come under the jurisdiction of their states' Attorneys General. We have been called the "local cops on the securities beat," and I believe that is an accurate characterization.

Securities regulatory offices are located in all 50 states and the District of Columbia, and Puerto Rico. We respond to investors who typically call us first with complaints, or request information about securities firms or individuals. State securities regulators work on the front lines, investigating potentially fraudulent activity and alerting the public to problems. Because we are closest to the investing public, state securities regulators are often first to identify new investment scams and to bring enforcement actions to halt and remedy a wide variety of investment related violations. We also work closely with criminal prosecutors at the federal, state and local levels to punish those who violate our securities laws.

The role of state securities regulators has become increasingly important as Americans rely on the securities markets to prepare for their financial futures. Today, we are a nation of 85 million investors. Over half of all American households are now investing in the securities markets.

Because of our proximity to the local investor, the states are an indispensable early warning system for fraud; state regulators then work with national regulators on market-wide solutions when they are required. That was the pattern followed with penny stock

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was founded in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

fraud, microcap fraud, day trading and other areas.[2] It bears repeating: the states investigate and bring enforcement actions – they do not engage in rulemaking for the national markets. That is rightly the purview of the SEC and the SROs.

We appreciate the Subcommittee's leadership in identifying some of the practices that resulted in the analyst conflict of interest inquiry, as well as the continuation of the work you started during the last Congress to enhance the SEC's criminal enforcement authority. H.R. 2179 provides securities regulators with additional tools to protect investors and strengthen the SEC's ability to penalize wrongdoers. But, even with the funding increase Congress allocated for the SEC and additional powers, the Commission can't go it alone. That is why there must be continued cooperation and shared labor among state, federal, and industry regulators.

H.R. 2179

NASAA applauds the Subcommittee for many of the provisions in The Securities Fraud Deterrence and Investor Restitution Act of 2003. We appreciate your commitment to strengthening securities regulation, and we want to work with you to reach our shared goals of enhanced investor protection and stiffer penalties for those who commit securities fraud. Given what's happened in the past few years on Wall Street and in boardrooms across the country, now is the time to strengthen, not weaken, investor protection.

NASAA fully supports giving the SEC the authority to impose civil monetary penalties in administrative cease and desist proceedings, with a right of judicial review by the court of appeals. This is consistent with state securities laws and with the Uniform Securities Acts of 1985 and 2002 (USA).

We also support significantly increasing the maximum fines that the SEC is able to impose on persons who violate Federal securities laws. Many of the current maximum penalty amounts that can be imposed on individuals who commit securities fraud are so small that they cannot have a deterrent effect on the violators. At a time when some corporate executives are making $50 million a year or more, these larger fines are critical if they are to have an effective deterrent or punitive impact on wrongdoers. The current low penalties could be seen by some not as a deterrent but simply a "cost of doing business."

Another provision we would support allows the SEC to seek financial records from a financial institution without first having to notify the customer. This is consistent with many state laws that allow regulators to subpoena bank records without notification to the customer if a risk of flight or dissipation of assets exists. These records can be transferred to any government authority under certain conditions without notification to the customer.

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[2] See State/Federal Dynamic Chart Attached

Section 8(b)

Although NASAA supports the vast majority of the provisions in H.R. 2179, I must express our deep concerns regarding Section 8(b). First, let me say that we share your goal of returning more funds to defrauded investors. We agree that restitution should be a priority of regulators. In fact, a primary and routine objective of state securities regulators is to obtain restitution for investors as part of enforcement actions. For example, in the 2001/2002 reporting period, state securities regulators collectively obtained orders for over $309 million in restitution. During the same period, roughly $71 million was ordered in fines and penalties.

To make the point that restitution is a priority, let me illustrate with some statistics from several states. In my home state of Maine, during the period from July 1, 2002 through May 31, 2003, my agency participated in the return of over $2.8 million to investor victims while collecting, apart from the Merrill Lynch settlement, only $16,000 in penalties to the general fund[3].

Data for Pennsylvania reflects the same priority. For Fiscal Year 2003 to date, the Pennsylvania Securities Commission oversaw the payment of $8.2 million in restitution/disgorgement and the collection of just $130,057 in civil penalties.

And during 2002, enforcement actions by the Arizona Securities Division led to payment of $222 million in restitution to investor victims and the collection of a comparatively modest $142,780 in penalties.

While we agree on the priority of restitution, there are provisions of H.R. 2179 that raise practical and public policy issues as well as the specter of unintended consequences that could actually harm investors.

We believe it would be bad public policy to attempt to direct a state authority to remit a civil penalty or disgorgement ordered in a state case to a federal governmental body for distribution. These funds rightfully belong to the investors or citizens in the state. Decisions regarding the use of penalties are best made by state legislatures and regulators so they can be tailored to the unique circumstances of each jurisdiction.

Under our reading of H.R. 2179, the states would lose control over the disposition of civil penalties obtained through efforts of state officials who are paid with state funding. Some states direct penalty monies back to enforcement activities and use the money to hire additional investigators and for other law enforcement purposes; others direct funds to investor education; and some to go to the general fund. All of these spending priorities serve the public good.

[3] The civil penalty examples for Maine, Pennsylvania and Arizona do not include the fines paid to those states in connection with the 2002 Merrill Lynch settlement.

Moreover, Section 8(b) has the potential to stifle state enforcement actions designed to protect investors. If the states are restricted in their ability to impose remedial actions they believe are necessary to curtail wrongdoing in their jurisdiction, they may be reluctant to impose beneficial remedies for fear of losing funds and support from within the state. This could conceivably have a chilling effect on us doing our jobs of protecting investors in your states.

State securities regulators apply a variety of sanctions when taking enforcement actions against brokers or dealers, depending upon the specific facts of each case. Remedial sanctions are an important enforcement tool in addition to restitution and monetary penalties. Where state securities regulators investigate and resolve enforcement cases using these remedies, their judgment regarding appropriate outcomes should be respected and supported.

For example, our routine remedies for selling unsuitable investments are to negotiate with the firms to return losses to investors and require the firm and/or the sales representative to address the underlying causes of the unsuitable investment. Those remedies often include having the branch manager review trades and compare them with the customer's investment objectives; requiring the representative to take specialized training; or requiring compliance or management procedures to anticipate problems.

In a case I investigated several years ago, a broker was able to steal money from his clients by asking their mutual fund companies to redeem shares and send the check to the client. The broker told the clients the checks were sent by mistake and should be returned. When the clients brought him the checks, he deposited them into his own account. My office required the firm to make restitution to the defrauded investors and institute new procedures to detect unusual levels of mutual fund redemptions. These specialized requirements for that case clearly went beyond what is required by federal law, but they were appropriate and carefully targeted remedies in that case.

The difficulty with Section 8(b) arises where states find it appropriate to combine these important remedial sanctions with penalties and restitution. Let's say a state securities regulator found that a branch office of a broker-dealer in its state had been selling an unusually high percentage of risky investments to elderly investors. The state may order the broker-dealer to make rescission offers to all investors, fine the broker and require the broker-dealer, for a fixed period of time, to keep a separate file on all transactions with senior citizens and provide reports to the Commissioner on such transactions. A review of Section 8(b) would suggest that the fine would have to be sent to the SEC for possible addition to the FAIR Fund. The troubling aspect of this illustration is that the state would have to send the fine collected to the SEC, even though the state had already arranged for the firm to make restitution to the victims.

Finally, the legislation leaves some open questions. It is unclear if it would apply if a state imposed the same remedial measures that were imposed in a parallel federal enforcement proceeding, where both the state and federal orders went beyond the requirements of federal law. The uncertainty in the mechanics of the bill points to another problem: when the state, the SEC and the industry respondent in a given case disagree on whether the provisions of Section 8(b) are triggered, how is that impasse to be resolved? This question suggests increased conflict between all three players, and resources being wasted in resolving such disputes.

In contrast with this scenario is the very positive experience in the recent global settlement with the leading Wall Street firms. In my view, the global investigation and agreement was a model for state-federal cooperation that will serve the best interests of investors nationwide.   We must be able to leverage our resources and continue to work together on such cases.   The federal-state-industry regulatory relationship is like a three-legged stool; if one leg is weakened, it can destabilize the entire structure. With 85 million investors relying on our securities markets to meet their financial goals and on regulators to keep those markets well policed, we can't afford to undermine our complementary regulatory system.

To sum up our concerns, while we wholeheartedly support the provisions in HR 2179 to strengthen the SEC's enforcement authority, it appears to be inconsistent policy to enhance the SEC's enforcement powers while at the same time inhibiting the states' options in enforcement actions.

Closing

Mr. Chairman and members of this Subcommittee, in closing, I want to repeat our support of the goals of this legislation. The SEC needs more authority and resources and those who break our securities laws should pay a higher price than they do today. But we are deeply troubled that this legislation, while strengthening the SEC, could weaken and limit the efforts of state securities regulators to protect investors in your states. Based on my experience as a securities regulator for the past 16 years, I believe that now is the time to strengthen, not weaken our unique complementary system of state, industry and federal regulation. Eighty-five million investors -- many of them wary and cynical -- expect us to remain vigilant, to work together, to stay the course and -- to make sure that Wall Street puts investors first. We cannot -- and we will not -- let these millions of investors down.

I pledge the support of the NASAA membership to work with you and your Subcommittee to provide you with any additional information or assistance you may need. Thank you for the opportunity to testify.

STATE/FEDERAL DYNAMIC:
HOW STATE DETECTION OF INVESTOR PROTECTION ISSUES LEADS TO NATIONAL RESPONSE

Issues Identified by State Securities Regulators	Problem	National Response
1989 - States determined Penny Stock offerings by newly formed shell companies to be per se fraudulent.[1] These "blank check" companies had no business plan except a future merger with an unidentified company.	**$2 billion/yr. Losses in Penny Stocks**[2]	1990- Congress passed Penny Stock Reform Act which mandated SEC to adopt special rules governing sale of Penny Stocks (<$5.00 per share) and public offerings of of shares in Blank Check companies (SEC Rule 419).[3]
1991 - States found that rollups of poorly performing public limited partnerships disadvantaged individual investors by not providing meaningful dissenters' rights.	**Lack of dissenters' rights**	1993- Congress passed the Limited Partnership Rollup Act which mandated that NASD adopt rules containing specific provisions to protect dissenters' rights.[4]
1996-97 - 33 States participated in sweep of 15 broker-dealer firms that specialized in aggressively retailing low-priced securities to individual investors. States found massive fraud in firms' manipulation of shares of start-up companies, most of which had no operating history.	**$6 billion/yr. Losses in Micro-cap Stocks**[5]	1997-98- Congress held hearings on fraud in the micro-cap securities markets (shares selling between $5-10). 2002 - Congress passed Sarbanes-Oxley Act which made certain state actions a basis for federal statutory disqualification from the securities industry.[6]

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[1] *Resolution of the North American Securities Administrators Association Declaring Blank Check Blind Pool Offerings to be Fraudulent Practices* (4 April 1989), NASAA Reports (CCH) ¶7028.

[2] *NASAA Investor Alert*: Penny Stock Fraud (December 1989).

[3] 15 U.S.C. §78o(g); 15 U.S.C. §77g(b)(1).

[4] 15 U.S.C. §78o(b)(12) and (13).

[5] Opening Statement of Senator Susan Collins, Chair, Senate Permanent Subcommittee on Investigations (22 September 1997).

[6] U.S. Senate Permanent Subcommittee on Investigations (22 September 1997 and 10 February 1998); 15 U.S.C. §78o(b)(4)(H); 15 U.S.C. §80b-3(e).

1996-97 - States were the first regulators anywhere to issue uniform interpretative guidance on use of Internet for legitimate securities offerings and dissemination of product information by licensed financial services professionals.[7]	**Risks of Securities offerings on The Internet**	1998- SEC issued interpretative guidance based on the States' Model on the use of Internet for securities offerings and dissemination of services and product information by licensed financial services professionals.[8]
1999 - In a report on trading of securities on the Internet, States found that investors did not appreciate certain risks, including buying on margin and submitting market orders.[9]	**Risks of Online Trading**	2001- SEC approved a new NASD rule requiring brokers to provide individual investors with a written disclosure statement on the risks of buying securities on margin.[10]
1999 - In a first-ever report on individuals engaged in day trading, States found that day trading firms failed to tell prospective investors that 70% of day traders would lose their investment while the firm earned large trading commissions.[12]	**Risks of Day Trading**	2000- SEC approved new NASD rules making day trading firms give written risk disclosure to individual investors.[11] 2001 - SEC approved new NASD and NYSE rules governing margin extended to day traders.[13]

[7] *Resolution of the North American Securities Administrators Association Regarding Securities Offering on the Internet* (7 January 1996), NASAA Reports (CCH) ¶7040; *Resolution of the North American Securities Administrators Association Regarding Internet Advertising of Information on Products and Services* (27 April 1997), NASAA Reports (CCH) ¶2191.

[8] *Statement of the Commission Regarding use of Internet Websites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore,* U.S. Securities and Exchange Commission, Release No. 33-7516 (23 March 1998).

[9] *From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage Industry*, Office of the New York Attorney General (22 November 1999).

[10] *Delivery Requirement of a Margin Disclosure Document to Non-Institutional Customers*, U.S. Securities and Exchange Commission, Release No. 34-44223 (26 April 2001).

[11] NASD Rules 2360 and 2361.

[12] *Report of the NASAA Project Group on Day Trading*, North American Securities Administrators Association (August 1999).

[13] NASD Rule 431; NYSE Rule 2520.